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No. 90-866

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1990

STANLEY KASAL, ET AL., PETITIONERS

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, ETC.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether on the facts of this case petitioners had to rely on a secret side agreement that failed to meet the standards of 12 U.S.C. 1823(e) and the doctrine enunciated in *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), in order to make out their defense against the FDIC's action to collect principal and interest on promissory notes.



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OPINIONS BELOW

The trial court's order (Pet. App. A2-A20) granting the Federal Deposit Insurance Corporation summary judgment is unreported. The opinion of the court of appeals (Pet. App. B1-B21) is reported at 913 F.2d 487.

JURISDICTION

The judgment of the court of appeals was entered on August 31, 1990. The petition for a writ of certiorari was filed on November 28, 1990. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. 1254(1).

STATEMENT

1. In the early 1980s, petitioner Francis Kasal had a number of loans outstanding at Citizens State Bank of

Gibbon in Gibbon, Minnesota. The loans exceeded the statutory limits on loans to a single individual by a bank, and Francis Kasal was informed by Dennis Albertson, the President of the Bank, that no further loans could be made to him. Albertson further advised Francis Kasal, however, that he could obtain additional credit from the bank if other parties signed notes payable to the bank. Pet. App. B3.

Francis Kasal proceeded to procure notes signed by his co-petitioners in a cumulative amount of over \$500,000. None of the co-petitioners received any funds in return for the notes. The co-petitioners allege that Albertson and Francis Kasal told them that the bank would not look to them for payment on the notes, but that the bank instead would rely solely on Francis Kasal for repayment. Pet. App. B3.

Francis Kasal and his co-petitioners admitted that, at the time the notes were signed, they were aware that Kasal had exceeded his lending limit, and that the purpose of signing the notes was to permit him to evade that limit. As Stanley Kasal admitted in answering an interrogatory:

On or about the date of the note [he] was approached by Francis Kasal and was told that Francis Kasal and Citizens State Bank of Gibbon had worked out a method or arrangement whereby the bank could lend additional monies to Francis Kasal over and above the lending limits of the bank. That arrangement was to have [Stanley Kasal] sign the note and have the money transferred to Francis Kasal. Defendant was assured by Francis Kasal that he would not be personally liable on the note and that all payments would be made by Francis Kasal. In later conversations with Dennis Albertson, these facts were never refuted * * *.

C.A. App. 557. See also C.A. App. 576 (Ruzicka), 582-583 (Martin), 587 (Francis Kasal). Petitioner Martin admitted that he was informed that the transactions were necessary

in part "in order to satisfy the bank examiners." C.A. App. 582.

Francis Kasal asserted that some of his debts were incurred for the benefit of Albertson. C.A. App. 587. The substance of Francis Kasal's claim regarding loans to Albertson is that, at Albertson's urging, Kasal on one occasion convinced a friend to borrow \$50,000 from the bank and transfer it to Kasal's account, from which \$30,000 was then transferred to Albertson.¹ Francis Kasal asserted that on another occasion, Albertson asked him to use farm equipment owned by Citizens State Bank to secure a loan at another Minnesota bank. Of the \$100,000 in loan proceeds transferred to Francis Kasal's account, \$90,000 was then assertedly transferred directly to Albertson. C.A. App. 587.

2. Francis Kasal was unable to pay the several promissory notes executed by his co-petitioners when they came due, and the bank commenced suit to collect on the notes in Minnesota state court in 1987.² On March 18, 1988, Citizens State Bank failed, and the FDIC was appointed receiver. In its capacity as receiver, the FDIC entered into a purchase and assumption transaction whereby "bad assets" owned by Citizens State Bank — including the notes at issue in this case — were conveyed from the receivership to the FDIC in its corporate capacity.³ Pet. App. A5-A6. The

¹ Under FDIC regulations (12 C.F.R. 337.3) it is illegal for an officer of a bank to borrow from his own bank without the specific approval of the bank's board of directors.

² The amounts of petitioners' obligations are reflected in the district court order. Pet. App. A7-A8.

³ The FDIC may act simultaneously in two separate legal capacities. In its capacity as "receiver," the FDIC may sell the bank's assets, while in its capacity as "corporation," it may purchase assets from the receiver. See 12 U.S.C. 1823(c)(2); *FDIC v. LaRambla Shopping Center, Inc.*, 791 F.2d 215 (1st Cir. 1986); *FDIC v. Lauterbach*, 626 F.2d 1327, 1330 n.4 (7th Cir. 1980); *FDIC v. Glickman*, 450 F.2d 416 (9th Cir. 1971).

FDIC intervened in the state court action, and removed the action to the United States District Court for the District of Minnesota.

The district court granted the FDIC's motion for summary judgment. Pet. App. A2-A20. Petitioners argued, *inter alia*, that they were not liable for the full amount of the notes in question because numerous payments had been made by Francis Kasal to reduce the balance due on the notes, but that Albertson had not in fact applied the payments for that purpose.⁴ Pet. App. A10-A11. In response, the FDIC pointed out that petitioners' defense required them to prove the alleged secret, unwritten agreement with Albertson whereby they (except for Francis Kasal) would not be looked to for repayment and that Francis Kasal's payments would be applied to reduce the outstanding balance on the notes. The FDIC argued that such a defense was impermissible under 12 U.S.C. 1823(e),⁵ as well as this Court's decision in *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942). Pet. App. A12-A13.

Noting that "[petitioners] should not be allowed to enter into a deceitful agreement and then complain that it was

⁴ Albertson was ultimately convicted of bank fraud, arising in part from his taking for personal use funds given him by Kasal. Pet. App. B4.

⁵ 12 U.S.C. 1823(e) provides in relevant part:

No agreement which tends to diminish or defeat the right, title or interest of the [FDIC] in any asset acquired by it under this section * * * shall be valid against the [FDIC] unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder * * * contemporaneously with the acquisition of the asset by the bank, (3) shall have been approved by the board of directors of the bank or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank.

not upheld" (Pet. App. A13), the district court held that their defense was barred. The court added that Francis Kasal's "extreme negligence in monitoring his financial transactions" supported the result and that, "by failing to take any steps to account for his payments, Kasal clearly 'lent himself to a scheme or arrangement' whereby the FDIC was likely to be misled." Pet. App. A14 n.3 (quoting *FDIC v. McClanahan*, 795 F.2d 512, 516-517 (5th Cir. 1986)).

3. A divided panel of the Eighth Circuit affirmed. The majority agreed with the district court that petitioners were essentially claiming that Albertson had failed to perform his promise—incorporated in unwritten agreements he entered into with petitioners—that he would apply payments made by Francis Kasal to the balances due on their notes. Pet. App. B7. The court agreed with the district court that the unwritten side agreements between petitioners and Albertson tended, in the terms of 12 U.S.C. 1823(e), "to diminish or defeat the interest" of the FDIC in the notes. Pet. App. B6-B7. Further, because the agreements were "not in writing," were "never * * * approved by the Bank's board of directors or loan committee," and "never were maintained as part of the Bank's records," they did not comply with the requirements of Section 1823(e) and were thus not valid against the FDIC. Pet. App. B7.

The court of appeals further noted that its decision was supported by the policies underlying Section 1823(e), and that the common law doctrine of *D'Oench, Duhme* "provides a separate and independent ground for holding that appellants may not rely on their secret unwritten side agreements." Pet. App. B8. The court also rejected petitioners' contention that "their defense of payment arises from the very same agreements that the FDIC is attempting to enforce." *Ibid.* The court found that, on the undisputed facts of this case, petitioners' "payment argument cannot be established without reference to their secret

unwritten arrangements with Albertson, which were not recorded on the books of the Bank and of which the FDIC had no knowledge." Pet. App. B9.

Judge Heaney dissented. Although he agreed with the majority that the FDIC is permitted "to recover the full balance due on the notes signed by Francis Kasal and his friends and relatives because the side agreements reached did not meet writing, approval, and filing requirements" (Pet. App. B16), he believed that Francis Kasal should nonetheless be permitted to prove at trial that "Albertson had in fact misappropriated" the funds alleged to have been paid "and that these sums should have been credited to the notes signed by him and the other borrowers." Pet. App. B15.

ARGUMENT

1. There is no dispute in this case that use of secret, unwritten agreements to "diminish or defeat" the FDIC's interest in petitioners' notes is proscribed by 12 U.S.C. 1823(e) and the *D'Oench, Duhme* doctrine. Thus, the only issue in this case is whether the particular claims of payment made by petitioners depend on proof of the alleged secret, unwritten agreements between themselves and Albertson.

Aside from Francis Kasal, petitioners' payment defense does not rely on proof of their own payments on their own notes; they do not and cannot assert that they themselves made payments to the bank or to Albertson that should have been credited to the balances due on their notes. Instead, petitioners claim that Francis Kasal made payments to Albertson, and that Albertson failed to apply such payments to their notes. Yet the only way to connect Francis Kasal's alleged payments to petitioners' notes is by proving the alleged secret side agreements in which they agreed to assist Francis Kasal and Albertson in evading the bank's statutory lending limits, and Albertson agreed to credit payments

made by Francis Kasal to their notes. Thus, the decision of both courts below that, on the particular facts of this case, petitioners' defense required proof of their secret agreements is correct and does not warrant further review.⁶

2. Petitioners' contention that the court of appeals' decision is in conflict with *FDIC v. Bracero & Revera, Inc.*, 895 F.2d 824 (1st Cir. 1990), and *Commerce Federal Savings Bank v. FDIC*, 872 F.2d 1240 (6th Cir. 1989), is mistaken.

a. Although a defense of payment was asserted in *Bracero*, that defense did not depend on proof of any side agreement that violated Section 1823(e) or the *D'Oench, Duhme* doctrine. In *Bracero*, the failed bank's board of directors knew of and approved the assumption of Bracero's debt by a third party. 895 F.2d at 826. The note that Bracero had executed to the bank was initially used as collateral by the third party on its own line of credit to the bank. Later, however, the third party executed its own note to the failed bank and used the proceeds to pay off Bracero's debt. *Ibid.* After the payment had been made, the failed bank "issued to Bracero a credit slip indicating that its debt had been cancelled," but the bank did not return Bracero's note. *Ibid.*

⁶ Petitioners do not raise or discuss the question whether Francis Kasal's defense of payment is legally distinct from the defense asserted by his co-petitioners, since Francis Kasal — unlike his co-petitioners — is asserting that *his own* alleged payments to Albertson should have been, but were not, credited to the balances due on his own notes. Nor did the court of appeals treat Francis Kasal's claim as distinct from those of his co-petitioners; although Francis Kasal's claims differed in some details from the claims of his co-petitioners, to prove his payment defense he too would have to prove the unwritten arrangements that he entered into with Albertson. In any event, the district court correctly found that, drawing all inferences in favor of Francis Kasal, his claim was nonetheless independently barred because, due to his "extreme negligence," he "lent himself to a scheme or arrangement whereby the FDIC was likely to be misled." Pet. App. A14 n.3 (internal quotation marks omitted).

When the FDIC, having taken over the failed bank, then attempted to collect on Bracero's note for funds due from the third party, Bracero successfully defended on the ground that its note had been paid in full.

The First Circuit upheld Bracero's payment defense because no secret, unwritten, or irregular agreement had to be proved in order to establish the defense. First, in contrast to the instant case—in which an unwritten agreement had to be proved in order to make out an essential premise of the payment defense—it was found as a matter of fact in *Bracero* that there was no unwritten agreement, yet the payment defense was nonetheless found valid. To be sure, the FDIC did advance the theory that Bracero had entered into such an agreement; the FDIC asserted that Bracero had intentionally failed to retrieve its note from the bank when its debt was assumed by the third party, thereby permitting bank examiners to be misled into thinking that the note secured the third party's debt. Yet the district court found "that Bracero's failure to retrieve the note was due to good faith neglect on Bracero's part and that there was no secret agreement." 895 F.2d at 829. The court of appeals held that conclusion not to be clearly erroneous. 895 F.2d at 830.

Second, even had there been a secret agreement of the sort asserted by the FDIC, the court of appeals held that it would not have had to have been proved in order to prove the payment defense, since the "note was invalidated by acts that were independent of the alleged secret agreement." 895 F.2d at 830. In contrast, because petitioners' payment defense requires proof of the secret agreements they allege, the balances of their notes were not paid by acts that were independent of the secret agreements.

b. In *Commerce Federal Savings Bank*, the Sixth Circuit reached much the same conclusion as the First Circuit had in *Bracero*. A deed of trust on a particular property had been given to C & C Bank to secure a \$125,000 loan

to the debtor. The deed included a "dragnet" clause, which provided that it would secure all future loans from the bank to the debtor as well. 872 F.2d at 1242. The debtor then sold the encumbered property to a subsidiary of Commerce Federal Savings Bank (Commerce), on condition that Commerce pay off the balance of the note. C & C Bank informed Commerce of the balance due on the note, received a payment in that amount from Commerce, indicated that the note was "paid in full" on its records, and later orally confirmed to a Commerce representative that the note had been paid in full and the deed of trust would be released. 872 F.2d at 1242-1243. Yet, when C & C failed and the FDIC discovered that C & C had at some point loaned another \$50,000 to the original debtor, the FDIC, relying on the "dragnet" clause, refused to release the deed of trust until the \$50,000 had been paid. *Ibid.*

The Sixth Circuit held that, under state law, "upon full satisfaction of the secured indebtedness, the security is extinguished as a matter of law." 872 F.2d at 1245. The court noted that the FDIC had failed to introduce any evidence that the \$50,000 note had been executed prior to the date on which Commerce had repaid the original note balance. Therefore, the court found that "the deed of trust was extinguished by operation of law by [Commerce's] payment * * * and, consequently, [the FDIC] failed to prove that the deed of trust was an 'asset' at the time" the FDIC acquired the assets of C & C Bank. 872 F.2d at 1246. Thus, as in *Bracero*—and unlike the present case—there was no unwritten agreement, and the payment defense was held valid because it did not depend on the existence of any such agreement.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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